

## Towards the end of any long-term incentive program for CEOs, the short term awaits – but it doesn't need to be bad news

*After the financial crisis, shareholders and regulators have become increasingly concerned about short-term pressures in business decision-making. **Moqi Xu** examines two potential remedies that firms use to set long-term incentives and what happens when they eventually run out. When long-term compensation eventually becomes available to executives, it rewards them for extremely short-term behaviour, such as timing news releases for their own personal benefit. When long-term employment contracts come close to the renewal decision, by contrast, executives are exposed to the scrutiny of the board, which forces them to focus and commercialize long-term investments previously made.*



### Long-term compensation can reward executives for long-term performance

The idea behind long-term compensation plans is to reward employees explicitly for measurable performance throughout a long period of time, thus reducing the pressures towards short-term, risky, behaviors. The most common form of long-term compensation is restricted stock or options that will only be accessible to the employee after a predetermined number of years (“vesting period”). Restricted stock and options are directly linked to shareholder value, in contrast to bonuses linked to certain performance thresholds. How long is “long-term”? In the U.S., the most common vesting period is three years, but it can be as long as seven years and as short as one year. The restriction matters to executives. Half of all CEOs sell shares in the months in which their stock becomes available to them (34 percent when they are options).

### Executives time news releases according to their vesting schedules

Long-term compensation matters. It has been [associated](#) with more long-term assets and greater R&D intensity. However, the longest lasting compensation eventually have to become available to the CEO to create wealth effects. In years when this happens, firms are more likely to [cut R&D and advertising expenses or to manage earnings towards just meeting forecasts](#).

In [new research](#), we find that executives change their behaviour precisely when their long-term compensation is due to vest. In particular, we find that executives strategically time news releases for personal gain in months when stocks or options become unrestricted (“vesting months”), compared to those when they do not.

Releasing news is an easy way to increase the short-term stock price, as news attracts attention to the stock. This attention also increases trading volume, which allows the CEO to sell their shares in a more liquid market. Indeed, news releases lead to significant increases in the stock price and trading volume in a 16-day window, but the effect dies down over 31 days, consistent with a temporary attention boost. The median CEO cashes out all of his vesting equity within 7 days, well before the effect reverses.

The increase in news releases only relates to discretionary news, which is within the CEO's control, and not others (such as scheduled earnings announcements). Moreover, the CEO reduces discretionary news releases in both the month before and the month after the vesting month, suggesting a strategic reallocation of news into the vesting month and away from adjacent months. CEOs not only release more news in the vesting month, but also more positive news – media articles immediately following these news releases contain significantly more positive words than normal.



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## Long-term employment contracts can shield executives from short-term pressures

Another way to set long-term incentives is to sign a long-term employment contract. Such contracts make it harder for the firm to terminate employment before the expiration date and therefore insulate the employee from short-term pressures. In my [research](#), I document that the probability of termination for a CEO with a five-year-contract is 73 percent higher in their first year, compared to their last. Moreover, concurrent performance measures only significantly affect the probability of leaving in the final two years of a contract.

In the U.S., [half of CEOs sign fixed-term contracts](#). Just like the typical time horizon for long-term compensation, the average contract term is three years. While employment contracts can be as long as ten years, only few of them are set to last longer than five years.

## Long-term employment contracts affect innovation and volatility

The investment policies of firms show a [distinct pattern that follows the employment contract horizon of the CEO](#). When their CEOs have more time left in their contract, firms invest into new and broader set of technologies, hire new inventors, and generate patents that later on receive more citations. The market is typically not able to judge whether all that activity is valuable: stock returns in those periods are more volatile, but not higher. And perhaps the CEOs themselves did not know beforehand which of their new investments would work out: not only is the average patent quality higher, but also the variance.

As the CEOs move towards the expiration of their contracts, their firms change their investment strategy. They become more focused into the most promising technologies and perform more incremental and less fundamental research. Stock market volatility decreases significantly, and so does the variance of innovation quality.

Does that pattern mean that CEOs become myopic towards the end of their contract and destroy long-term shareholder value? Not necessarily. Pressure can make us more disciplined and focused, force us to cut down our favourite projects that have not generated promising results (yet...) and to care about the bottom-line. The disciplining effect of career-related pressure is the reason why many shareholders wish it to be easier to oust badly performing CEOs, call for more transparency and less takeover protection.

Renewal decisions are made by boards that should take both long- and short-term performance measures into account. Arguably they are harder to manipulate than stock prices that determine the value of long-term compensation incentives. However, contract length has a clear disadvantage compared to compensation schedules. Contracts cannot be renewed to be constantly long-term because the renewal decision itself generates

a short time horizon and short-term pressure. In contrast, firms can replenish compensation schedules by giving the CEO new long-term grants and even use a mix of grants to set both long- and short-term incentives. In the end, firms must take these trade-offs into account and find a balance between the benefits of short- and long-term incentives.

*This article is based on the papers ‘[Strategic News Releases and Equity Vesting](#)’ (with Alex Edmans, Luis Goncalves-Pinto and Yanbo Wang), ‘[CEO Job Security and Volatility](#)’ (with Peter Cziraki), and ‘[Corporate Innovation Cycles and CEO Contracts](#)’ (with Juanita Gonzalez-Urbe). The author gratefully acknowledges financial support from STICERD, the NBER Innovation, Policy, and the Economy group and the Abraaj Group.*

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